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INTERGOVERNMENTAL NEGOTIATING COMMITTEE
FOR A FRAMEWORK CONVENTION ON CLIMATE CHANGE
Ninth session
Geneva, 7-18 February 1994
Item 3 (a) and (b) of the provisional agenda

MATTERS RELATING TO ARRANGEMENTS FOR THE FINANCIAL MECHANISM AND FOR TECHNICAL AND FINANCIAL SUPPORT TO DEVELOPING COUNTRY PARTIES

IMPLEMENTATION OF ARTICLE 11 (FINANCIAL MECHANISM), PARAS. 1-4

CONSIDERATION OF THE MAINTENANCE OF INTERIM ARRANGEMENTS REFERRED TO IN ARTICLE 21, PARA. 3

Issues to be addressed by the Committee

Note by the interim secretariat

I. SCOPE OF THE NOTE

1. At the eighth session of the Committee, Working Group II decided to focus its work on the implementation of Article 11 (Financial Mechanism) and considered, in particular, (a) policies, programme priorities and eligibility criteria; (b) modalities for the functioning of operational linkages between the Conference of the Parties (COP) and the operating entity or entities entrusted with the operation of the financial mechanism (hereafter referred to as "the operating entity or entities"); (c) approaches to the determination of "agreed full incremental costs"; and (d) elements relevant to the assessment of needs for funding from the Global Environment Facility (GEF) for activities related to the Convention in the three years 1994-1996. The conclusions adopted by the Committee are contained in its report, document A/AC.237/41, paras. 82-92.

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2. The present note, prepared to facilitate the work of the Committee at its ninth session, takes stock of progress achieved in the above-mentioned areas and identifies issues that need to be addressed in the areas of (a) guidance from the COP to the operating entity or entities; (b) positions that the COP could adopt regarding modalities for the operational linkages between the COP and the operating entity or entities; and (c) institutional questions.

3. The present note is supplemented by two addenda, one on approaches to the determination of agreed full incremental costs, and the other on the outcome of the replenishment and restructuring process of the GEF.

II. GUIDANCE FROM THE CONFERENCE OF THE PARTIES TO THE OPERATING ENTITY OR ENTITIES

4. At its eighth session, the Committee considered that in order to implement the provisions contained in the Convention further work would be needed on policy guidance regarding the scope of the financial mechanism (relevant elements of Articles 4.1, 4.3, 4.4, 4.5, 4.8, 11.1, 11.5), eligibility criteria other than those agreed in subparagraph 84(ii) of document A/AC.237/41 and programme priorities other than those agreed in subparagraph 84(iii) of the same document (A/AC.237/41, para. 85).

5. The Committee also resolved to give priority at its ninth session to consideration of the implementation of Article 11 (Financial Mechanism) and to the adoption of such recommendations for decisions by the COP as might be necessary, in the context of the mandate of the COP, on guidance to the operating entity of the financial mechanism concerning its policies, programme priorities and eligibility criteria related to the Convention, and on the determination of "agreed full incremental costs" (A/AC.237/41, para. 91).

A. Eligibility criteria

6. On eligibility* criteria, the Committee achieved some progress and reached general agreement on the following:

> "Eligibility criteria will apply to countries and to activities and will be applied in accordance with Article 11.1, 11.2 and 11.3. Regarding eligibility of countries, only countries that are Parties to the Convention would be eligible to receive funding upon the entry into force of the Convention. In this context, only developing country Parties would be eligible to receive funding through the financial mechanism, in accordance with Article 4.3." (A/AC.237/41, para. 84)

7. The Committee may wish to consider whether it envisages the development of additional eligibility criteria for countries.

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* "Eligibility" is defined as "fit or worthy to be chosen" (Chambers's Twentieth Century Dictionary, Revised Edition, 1971).

8. Concerning eligibility of activities, Article 4.3 envisages funding for two broad categories of activities:

(a) Those related to obligations under Article 12.1 to communicate information for which the "agreed full costs" are to be met; and

(b) Measures covered by Article 4.1 for which the "agreed full incremental costs" are to be met under specified conditions.

9. Whilst there appeared to have been consensus on the eligibility of activities envisaged under Article 12.1, it was not clear from the discussions whether all measures referred to in Article 4.1 were unanimously considered eligible for funding through the financial mechanism. The same applies to Article 4.4 which establishes a commitment on the part of the developed country Parties and other developed Parties included in Annex II to assist those developing countries that are particularly vulnerable to the adverse effects of climate change in meeting the costs of adaptation to them. In the light of these provisions, the Committee may wish to consider:

(a) Whether the adaptation measures and activities mentioned in Article 4.1 are eligible for funding through the financial mechanism;

(b) Whether the measures and activities covered by Article 4.4 are eligible for funding through the financial mechanism;

(c) Whether the resolution of question (b) could be achieved through the designation of different entities for the operation of the financial mechanism in this regard. (See also para. 24, below); and

(d) If some of the measures mentioned in Article 4.1 and 4.4 are not eligible for funding through the financial mechanism, how the commitments to provide funding for their implementation will be discharged.

B. Programme priorities

10. Some progress was made in the determination of priorities. At the eighth session, it was agreed that priority should be given by the financial mechanism to the funding of the agreed full costs incurred by developing country Parties in complying with their obligations under Article 12.1 regarding communication of information. It was also agreed that in the initial period, emphasis should be placed on enabling activities undertaken by developing country Parties, such as planning and endogenous capacity building (including institutional strengthening, training, research and education), that will make it possible to implement larger-scale response measures. The Committee considered that further work would be needed on programme priorities other than those mentioned above (A/AC.237/41, para. 85). The Committee may wish to consider setting additional priorities regarding types of activities.

11. Article 4.5 deals with the transfer, or access to, environmentally sound technologies and know-how. An issue in this regard may be the identification of environmentally sound technologies and know-how deserving priority support, particularly as regards their application in developing country Parties. The Committee may wish to recommend to the COP a process for such identification, possibly involving the Subsidiary Body for Scientific and Technological Advice.

C. Policies

12. Regarding policy guidance to be provided by the COP to the operating entity or entities, the conclusions adopted by the Committee at its eighth session do not go beyond the language contained in the Convention. The discussion, however, clarified that areas listed in Article 11.3(a), (b), (c) and (d), being areas in which the COP and the entity or entities are to agree upon arrangements, are excluded from the field of policy guidance to be unilaterally given by the COP to the entity or entities. These matters are dealt with in section III, below.

13. The Committee may wish to envisage which issues other than eligibility criteria and programme priorities could be the subject of policy guidance from the COP to the entity or entities. In that connection, the Committee, at its eighth session, considered that further work would be needed on policy guidance regarding the scope of the financial mechanism (see relevant elements of Articles 4.1, 4.3, 4.4, 4.5, 4.8, 11.1, 11.5).

14. In Article 4.3 the expressions "agreed full costs" and "agreed full incremental costs" are utilized. The Committee may wish to consider whether such costs should be determined entirely through a bilateral discussion between the developing country concerned and the entity or entities, or whether some guidelines, criteria or methodologies for the determination of such costs should be established by the COP. Such guidelines, criteria or methodologies would provide a framework within which bilateral discussions would take place. It may be recalled in that connection, that the Committee decided to address the issue of guidance on the determination of "agreed full incremental costs" at its ninth session (A/AC.237/41, para. 91).

15. The Committee may wish to consider the issue of guidance that the COP may provide to the entity or entities regarding activities funded through them outside the financial mechanism of the Convention. Such activities may be carried out to implement a funding commitment under the Convention (for example, support regarding transfer of technology to Parties other than developing country Parties as provided for in Article 4.5), or to assist a Party that is not eligible for funding under the financial mechanism in taking measures to limit emissions.

16. The Committee may also wish to consider:

(a) How the concerns expressed in Article 4.8 and 4.9 could be reflected in terms of programmes;

(b) Whether the COP could provide guidance on the distribution of funds available to the operating entity or entities for climate change among groups of countries (for example, eligible and non-eligible) and regions; and

(c) Whether the COP should give guidance to the operating entity or entities on when funding is to be provided in the form of grants and when in the form of concessional finance.

III. MODALITIES FOR THE FUNCTIONING OF OPERATIONAL LINKAGES BETWEEN THE CONFERENCE OF THE PARTIES AND THE OPERATING ENTITY OR ENTITIES

17. At its eighth session, the Committee reached preliminary conclusions on some aspects of the modalities for the functioning of the operational linkages between the COP and the operating entity of the financial mechanism. Issues relating to reporting, accountability, conformity and reconsideration of funding decisions were addressed in the preliminary conclusions adopted by the Committee (A/AC.237/41, para. 86). As these modalities are to be agreed between the COP and the operating entity or entities, these preliminary conclusions would constitute positions that the COP could adopt in seeking arrangements with the operating entity or entities.

18. The Committee decided that further work will be needed on Article 11.3(d) in conjunction with its chapeau. This deals with modalities for the determination, in a predictable and identifiable manner, of the amount of funding necessary and available for the implementation of the Convention and with the conditions under which that amount shall be periodically reviewed in accordance with the provisions of Article 11.3 (A/AC.237/41, para. 87).

19. Arrangements for cooperation between institutions established by the Convention, that is, the secretariat and the subsidiary bodies and their counterparts in the operating entity or entities, would support the operational linkages established. The Committee may wish to develop its position on these arrangements.

IV. INSTITUTIONAL QUESTIONS

A. GEF restructuring

20. Article 21.3 entrusts to the GEF, on an interim basis, the operation of the financial mechanism referred to in Article 11. Article 21.3 also calls for the GEF to be restructured and its membership made universal to enable it to fulfil the requirements of Article 11. Article 11.2 provides that the financial mechanism shall have an equitable and balanced representation of all Parties within a transparent system of governance. Article 11.3 addresses an agreement between the COP and the entity or entities on the functioning of operational linkages between them. Article 11.4 calls on the COP, at its first session, to make arrangements for the implementation of Article 11.3(a), (b), (c) and (d) and, at the same session, to review the interim arrangements entrusting the GEF with the operation of the financial mechanism on an interim basis and to decide whether these interim arrangements shall be maintained. Within four years thereafter the COP is to review the financial mechanism and take appropriate measures.

21. On completion of the restructuring of the GEF, the Committee may wish to consider whether the restructured GEF corresponds to characteristics outlined in Articles 11.2 and 21.3 and advise the COP in that regard.

B. Agreement between the COP and the operating entity or entities

22. On arrangements between the COP and the operating entity, the legal opinion requested from the United Nations Office of Legal Affairs on appropriate arrangements which might be entered into between the COP and the operating entity has been received, and concludes as follows:

> "Having reviewed the questions raised by the [secretariat of the] INC/FCCC, this Office is of the opinion that in accordance with the relevant provisions of the United Nations Framework Convention on Climate Change, the Conference of the Parties (COP) has the legal capacity, within the limits of its mandate, to enter into agreements and other arrangements with entities, such as states, intergovernmental and non-governmental organizations and bodies, which also have the authority to do so. The Global Environment Facility, which was established on 14 May 1991 by resolution 91-5 of the Executive Directors of the World Bank, does not, at the present time, have the legal capacity to enter on its own into agreements or arrangements with other entities. If the COP wanted to use the present GEF as an operating entity, it would have to enter into an agreement or an arrangement with the World Bank as the parent organization. It is not possible at this stage to predict with any certainty whether a restructured GEF will have the legal capacity to enter on its own into agreements or other arrangements with entities such as the COP. Likewise, it is not feasible to determine in general which arrangements should be considered as appropriate between the COP and a hypothetical operating entity. As far as the question of the most appropriate arrangement between the COP and the GEF, as an operating entity, is concerned, the answer to it depends on the status and structure of the new GEF."

23. The Committee may wish to consider the matter in the light of that initial opinion and of any other opinion that might be forthcoming once arrangements for a restructured GEF are concluded. The Committee may also wish:

(a) To decide on arrangements for agreeing with the entity or entities on modalities for the functioning of operational linkages;

(b) To complete the formulation of its position regarding Article 11.3; and

(c) Provided that the advice referred to in para. 21, above is positive, to initiate a process of discussions with the GEF in preparation for an agreement between the COP and the GEF.

C. Involvement of other entities in the operation of the financial mechanism

24. Article 11.1 provides that the operation of the financial mechanism shall be entrusted to one or more existing international entities. It may be found useful to assign different tasks under the financial mechanism to different entities on the basis of their respective fields of activity. The following issues could be addressed in that connection:

(a) On what criteria and at what stage should entities other than the interim entity be given consideration?

(b) Could, for instance, additional entities be entrusted with the operation of the financial mechanism only on the occasions mentioned in Article 11.4 for the review of arrangements, or also at other times?

(c) What arrangements (for example, involvement of a subsidiary body) would be required to provide for an effective interaction between the COP and the entities entrusted with the functioning of the financial mechanism?

D. Funding through bilateral, regional and other multilateral channels

25. Finally, Article 11.5 discusses funding through bilateral, regional and other multilateral channels. The Committee may wish to consider what role the COP is to play in monitoring and providing guidance, if any, for such funding operations, and what arrangements may be needed with institutions implementing them. Regarding monitoring, it may be recalled that Article 12.3 provides that each developed country Party and each other developed Party included in Annex II shall incorporate in its communication to the COP details of measures taken in accordance with Article 4.3, 4.4 and 4.5 relating to finance and the transfer of technology.

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CONSIDERATION OF THE MAINTENANCE OF INTERIM ARRANGEMENTS REFERRED TO IN ARTICLE 21, PARA. 3

Issues to be addressed by the Committee

Addendum

APPROACHES TO THE DETERMINATION OF AGREED FULL INCREMENTAL COSTS

Note by the interim secretariat

I. SCOPE OF THE NOTE

1. At its eighth session, the Committee resolved to give priority at its ninth session to consideration of the implementation of Article 11 (Financial Mechanism) and to the adoption of such recommendations for decisions by the Conference of the Parties (COP) as might be necessary, in the context of the mandate of the COP, on guidance to the operating entity of the financial mechanism concerning its policies, programme priorities and eligibility criteria related to the Convention, and on the determination of "agreed full incremental costs" (A/AC.237/41, para. 91).

2. Considering the need for additional analysis of the issue of agreed full incremental costs, the Committee requested the interim secretariat to prepare another document for consideration at its ninth session, taking into account, inter alia, comments made by delegations at the eighth session (A/AC.237/41, para. 89).

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3. The present note has been prepared in response to that request. It draws on the contents of document A/AC.237/37/Add.2 submitted to the eighth session, on comments made by delegations at that session, on work carried out in the context of symposia convened by the secretariats of the Global Environment Facility (GEF) and of the United Nations Development Programme (UNDP), as well as on contributions by the non-governmental sector. It identifies a number of issues with respect to the determination of agreed full incremental costs on the basis of the information obtained from these sources.

II. BACKGROUND

4. "Agreed full incremental costs" are referred to in Article 4 (Commitments) of the Convention. Article 4.3 provides that the developed country Parties and other developed Parties included in Annex II shall provide new and additional financial resources, including for the transfer of technology, needed by the developing country Parties to meet the agreed full incremental costs of implementing measures that are covered by Article 4.1 and that are agreed between a developing country Party and the international entity or entities entrusted with the operation of the financial mechanism. (This commitment follows another for the funding of the agreed full costs incurred by developing country Parties in complying with their obligations under Article 12.1.)

5. The approach to calculating agreed full incremental costs will be important in determining the amount of funding to be received by the developing country Parties through the financial mechanism in support of their implementation of activities listed in Article 4.1. These will represent an important part of the implementation of the Convention as a whole. Other applications of incremental costs could include the ranking of projects on the basis of their cost-effectiveness in achieving the objective of the Convention.

III. CONSIDERATIONS AND ISSUES

6. The concepts of additionality and incrementality are linked in the same paragraph of the Convention and may be seen to constitute two complementary concepts. As neither concept is rigorously defined and their practical application meets with difficulties, pragmatism will have to prevail in applying both concepts in practice As far as incremental costs are concerned, approaches have been developed in various institutions to design an operational methodology. A number of issues found in such approaches are outlined below.

A. System boundary

7. Costs to be taken into consideration for assessing incrementality should, as appropriate, include capital costs, operating costs and initial costs as well as those occurring later. The costed measures may be precisely delineated, but their implementation may involve costs affecting -- beyond the project or enterprise -- the whole economy or a sector thereof. An appropriate "system boundary" should be chosen that includes all important elements economically affected by the measures. Whether and how, indirect, induced or opportunity costs should be taken into account is an issue in this regard.

B. Baselines

8. Incremental costs will be defined vis-à-vis a baseline situation, which could be not to implement a measure at all, or to implement it in a manner that does not aim at achieving the objective of the Convention. The incremental cost will be the difference between the cost of the baseline activity (which may be zero) and that of the actually implemented measure.

9. Baselines, which are essential for defining incremental costs, are necessarily hypothetical; defining them constitutes a major issue in the determination of incremental costs and is inevitably a matter for negotiation among the parties concerned. There will be a need to apply rules of economic, environmental, technical and financial reasonableness in defining baselines.

10. In the field of climate change, incremental costs are very sensitive to both the proposed measures and the baseline. In cases where the latter is specific to the country situation, this may complicate any attempt to codify standard incremental costs on the basis of an indicative list of measures. However, the determination of incremental costs would be facilitated by the development of model projects, corresponding to the substitution of typical baseline activities by typical alternatives.

C. Costs and benefits: gross or net costs

11. The consideration of various economic implications of implemented measures, including indirect implications, leads to considering both costs and benefits generated by the measures. Benefits should include the economic benefits initially intended by the baseline measures, as well as global benefits relevant to the aim of the Convention. They may also include additional local benefits, which may be in the form of avoided costs (for example, fuel savings realized by substituting a hydroelectric plant for a thermal one) or in the form of indirect, incidental benefits (such as, in the above example, tourism development linked to the availability of a lake).

12. This raises the issue of the treatment of such local incremental benefits in the determination of the agreed full incremental costs of these measures. An economic approach would suggest the subtraction of such local benefits from the costs so that only net incremental costs would qualify for financing. Whether to fund gross or net costs under the Convention is an important policy issue .

13. The implementation of the net cost approach would have the effect of concentrating funds channelled through the financial mechanism on the achievement of the objective of the Convention and of avoiding the use of resources from the financial mechanism for the generation of incremental local benefits for the developing country hosting the project. This could be viewed as consistent with a strict distinction between development funding and global funding. Such an approach could also be seen as consistent with the aim of maximizing the extent to which the objective of the Convention is approached, for a given amount of funding available through the financial mechanism.

14. Another effect of the net cost approach would be that measures that are locally economic, in that their local benefits exceed cost, would not be eligible for financing through the financial mechanism. Other activities with substantial local benefits would see their grants curtailed. Typically, such environmentally preferable projects would have higher initial costs than the baseline ones, so that the financing available to the host country for the implementation of the baseline measure would not be sufficient for the implementation of the alternative project.

15. The fact that the alternative project is economic or has important local benefits does not guarantee that the additional funds required will be available domestically or from external -- public or private -- sources. The financing of such projects deserves attention, as the projects concerned are among the most desirable ones, both economically and environmentally, and may constitute a substantial proportion of the mitigation measures useful for the implementation of the Convention. Such projects could be supported by the provision of loans -- with appropriate degrees of concessionality -- rather than grants, or by the provision of assistance in securing funding from other sources. Recourse to joint implementation would be an option in this regard, once criteria are agreed by the COP. Another approach would be to apply the rule of subtracting incremental local benefits with flexibility, particularly with respect to indirect and uncertain benefits.

16. In fact, the current practice is neither full compensation of incremental costs, nor full subtraction of local benefits. In the case of the Montreal Protocol, for example, the Multilateral Fund is only required to take savings and benefits "into account". In the operational interpretation of this provision developed by the World Bank, this is taken to mean that direct financial savings would be subtracted from the overall cost of the measure being implemented, while other types of domestic benefits -- such as environmental and intangible benefits, side benefits not financially justifiable on their own by the country concerned and benefits that are contingent or uncertain -- would not be subtracted in full, or not subtracted at all. A similar interpretation is being adopted in the operations of the Global Environment Facility (GEF).

17. Moreover, projects that appear to be economic, and therefore ineligible, could be viewed as eligible if a number of related costs that are less easy to quantify -- such as costs of risks, transactions, information gathering or market development -- were included in the "system boundary".

18. Some of the most cost-effective interventions are likely to be not projects but shifts of entire sectoral development plans, aimed at reducing emissions of greenhouse gases. In such cases one would need to compare the cost of a proposed plan with that of a baseline plan rather than operate on a project-by-project basis.

D. Discount rate

19. The consideration of costs -- occurring at different times, whether capital costs or operating costs -- leads to the need to determine and apply a discount rate. Some analysts, emphasizing intergenerational equity, recommend the use of a low discount rate to account for the long time horizon of the climate change phenomenon. Others feel that funds spent on climate change mitigation measures should be able to yield the same returns as development projects and, therefore, that these measures should be screened by the same discount rates.

20. As the determination of agreed full incremental costs does not include the valuation of global environment benefits, the use of the same discount rates as for other development projects seems warranted. Choosing a disbursement method -- either compensating costs as and when they are incurred, or making a lump sum payment compensating discounted costs -- is another issue to be addressed in deciding a financing strategy.

IV. CONCLUSION

21. The above issues, as well as others encountered in approaches to the determination of incremental costs, suggest that policy guidance on certain general aspects of such approaches would be needed. This could take the form of methodological guidelines, within which each grant would be decided through discussions between the eligible country and the operating entity concerned. In designing such a set of guidelines, care would have to be taken to achieve an effective utilization of available resources, while providing an incentive for eligible countries to implement the Convention.

22. The Committee may wish to consider whether to recommend that the COP should provide guidance on common methodological guidelines for determining agreed full incremental costs. In such a case, the COP could seek advice for this purpose from its Subsidiary Body for Scientific and Technological Advice. In providing support as required in this regard, the secretariat would draw on current activities in various institutions and in particular on work being carried out in the PRINCE programme under the auspices of the Office of the Administrator of the GEF.

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Addendum

OUTCOME OF THE PARTICIPANTS' MEETINGS OF THE GLOBAL ENVIRONMENT FACILITY (GEF)

Note by the interim secretariat

1. Since the Committee's eighth session, the Participants in the Global Environment Facility (GEF) have held three further rounds of meetings on the replenishment and restructuring of the Facility (Washington, D.C., 22-24 September; Paris, 4-6 November; Cartagena de Indias, 6-10 December 1993). Despite intensive work, it has not yet been possible to reach a comprehensive agreement encompassing these two topics.

2. Efforts are continuing to negotiate an overall consensus that would permit the establishment of the restructured and replenished Facility, referred to as "GEF II". This would function for the three years following the expiry of the present GEF pilot phase, namely, from 1 July 1994 to 30 June 1997. It is understood that an attempt will be made to secure consensus on GEF II early in 1994.

3. In view of the uncertainty regarding the outcome and timing of negotiations on GEF II, it is premature to propose a timetable for the work of Working Group II at the ninth session of the Committee on matters relating to the financial mechanism of the Convention. Consequently, it would be prudent to provide time for consultations at the start of the ninth session, before Working Group II starts this work. Moreover, if the negotiations on GEF II have not been concluded by the time the session starts, it will be necessary to review provisional agenda items 3 (a) and 3 (b) concerning the financial mechanism and to determine how best to deal with them.

4. Any further developments relating to the replenishment and restructuring of the GEF will be reported to the Committee in a further addendum.